<u>DRAFT MINUTES</u>

Subcommittee on Sales and Excise Tax Modernization
State and Local Fiscal Modernization Study Commission
Tuesday, January 16, 2007
10:00 AM
Suite 300 Conference Room, LOB

The Subcommittee on Sales and Excise Tax Modernization met on Tuesday, January 16, 2007 at 10:00 AM in the suite 300 conference room of the Legislative Office Building. Sub-Committee Chair Tom Ross, Senator Pete Brunstetter, Randall Fraser, Linda Jones, and Benjamin Russo were in attendance. A list of visitors is attached and numbered as attachment #1.

Mr. Ross welcomed the group to the first formal meeting of the subcommittee and then discussed the agenda and list of attachments that were sent via e-mail to the committee members.

Attachment #2	Agenda
Attachment #3	Sales Tax Clearinghouse by State
Attachment #4	2004 State and Local Revenue
Attachment #5	2004 State and Local Revenue as a Percentage of Personal Income
Attachment #6	State Sales Tax Rates: January 1, 2006
Attachment #7	Recent State Tax Reforms Affecting State Sales Taxes
Attachment #8	Description of Florida’s Attempt to Tax Services in 1987
Attachment #9	Sabra Faires’ Response to Governor’s Commission to Modernize State Finances
Attachment #10	Executive Summary: Streamline Sales Tax Project
Attachment #11	E-Mail Response from Andy Sobol, Director of Sales and Use Tax Division, Dept. of Revenue
Attachment #12	Final Report of the Governor’s Commission to Modernize State Finances

At the introductory meeting held last month the committee decided to begin with some discussion of where people were based on what they have heard so far and on their knowledge of what this work is in terms of some basic principals of general sales tax reform.

One of the items this committee is charged with is to determine weather or not the existing sales tax is equitable. Equity is defined in that every citizen should be assured of receiving uniform and sufficient opportunities for essential services on the service side. The tax side of this issue is that the current system with differential rates may not always be equitable. This is one item that should be discussed concerning differential rates.

There are also exemptions from the sales tax, food tax being the largest. Most services are not exempt, but simply not taxed. If services are not exempt, should they be examined and included again as part of the base for sales tax as separate?

The committee has been charged with exploring ways to broaden the base for purposes of lowering the rates. This will be an exercise in looking at the structure of how we collect taxes in NC. How does the current sales tax work in relation to our modern economy, which is increasingly service based? Also, if services were included, what would the impact be on the rates and taxpayers? The sales tax doesn’t stand alone. If you broaden the base here and then lower the rate in another area, how much you can lower the rate depends on what you might do with the corporate and individual income tax. These are the three general principals and we should discuss how people feel about these issues.

Mr. Russo explained the report written by Sabre Faires was a few years old and some of the items listed have changed. Changes have been made where the tax burden has shifted or items are now exempt. Example: Tax rates of telecommunications and spirituous liquor have been changed to 6.75%. Implementing taxes and the difficulty of administering and complying with taxes are complicated by the difference in rates. Unfortunately, for some of these rates there are no apparent economic or administrative justifications for the differences in rates in some areas.

Based on the actions taken since 2002, there are still some preferential rates. Example: The 3% rates on boats and aircraft, 2% rate with a $300.00 cap on manufactured homes, 2 ½ % rate on modular housing that is not on this list and was imposed after the document was produced and there are still preferential rates on electricity. The 3% to most residential users, manufactures receive a 2.83% reduced rate, and on July 1, 2007 that is set to go down to 2.6%. There is an exclusion in the Streamline Sales Tax Agreement that allows states flexibility in these areas.

Example: Piped natural gas is exempted from sales and use tax, but there is another excise tax imposed based on the therms delivered each month and that is administered by the local distribution companies. They collect the tax based on the number of therms that they deliver to a customer each month. This item has seven different rates based on the amount of usage from .40 down to .07 cent based on the amount used each month.

Why is natural gas treated differently than electricity? Many out of state companies were responsible for the sale and their were questions on weather you could hold these companies responsible for the tax without their actual presence in NC. Also, their were some issues related to exemptions with the producers and how this should be taxed. The General Assembly decided to make changes and now it doesn't matter who makes the sale as the tax is now based on the amount of gas used. Unfortunately, high end users pay reduced amounts based on more consumption; however we don't discount electricity in the same manner.

If simplification is one of the goals in for this new system, how realistic is it to expect us to simplify these rates when they are set this way to address competitive concerns with neighboring states? How likely is it going to be that we will be able to get away from differential rates? One of the opportunities that presents itself when you broaden the base is that you can lower rates and maybe you can lower them enough so the competitiveness concerns on particular items is eliminated and you end up with a uniform application rate. The economic theory is that when you apply different rates, you create differential incentives and these raise equity and economic efficiency issues. Also, some of these can not be changed based on commitments that were made with particular firms and companies.

Ms. Jones brought up the question that if it depends on how broad the base is weather you have differentiating rates, should the discussion of broadening the base take place initially and then work your way back to the rates? Mr. Ross acknowledged that the possibility of actually accomplishing the elimination of differential rates would be easier if you have a broader base so you can lower the rate. Everything is so inter related that it will be such a long process and decisions must be made on a tentative basis.

What criteria should we use as a committee to make a judgment that the tax rate weather it is 4% or 4 ½ % or 3 ½ % puts us where we want to be? What should the tax rate be at the state level that is competitive and sufficient for the state and how do you figure that out and then how do we apply it? Ultimately, it isn't our job to determine the "correct rate". That decision will be left the General Assembly based on what the needs of the State are at the time. The goal of the committee should be to set a structure in place that makes this task easier and will grow with the economy and hopefully reduce the need to move the rates around from year to year. Only if you need to increase the spending needs of the State would you then need to increase the revenue of the State.

Mr. Ross' opinion on the competitiveness of the NC tax rates is that most people who are concerned about bringing a business to our state or keeping a business here are more worried about the total tax rate. Overall high rates are discouraging to potential businesses and if you lower the rates across the board, the more competitive North Carolina appears to be. At this time, NC is ranked very high in our ability to attract business because our overall tax rate is fairly low in NC in comparison to other states.

Also, some areas such as Charlotte, Asheville, Raleigh, and Wilmington are growing much faster than other areas and they will have different views on the tax structure. Who should have the ability to make the decisions on healthcare or school construction? Should these decisions be left to local government or handled by state government. This has a huge impact on where you access the tax.

The food tax exemption was removed in 2002 and now we have an argument is should be tax this again. It was assumed that this tax hurt low income individuals in NC. There are many ways to address the folks at the lower end of the income scale. When the food tax was removed, individuals who could afford to pay the tax on food then received the benefit of the tax cut and that action may have cost the State in resources, but also narrowed the base significantly.

For purposes of moving forward, the commission needs to design a system that is equitable, competitive, sufficient in revenue production, and encourages simplicity and efficiency in tax collection. Ideally the system will foster an appropriate relationship between state and local government. This is what pushed the 2002 commission in the direction to broaden the base and we need to eliminated exemptions and differential rates.

Carl Smith was asked to explain the tax calculator. With this tool you can choose what you want the sales tax rate to be and then you can decided if you want to include other things in the base of the sales tax that are not included right now. This all comes from Consumer Expenditure Survey Data which is from the Census Department. The categories that are used on the survey are healthcare expenditures (drugs and hospital stays, not including doctor visits which go under direct professional services with accountants and lawyers), direct professional services, entertainment, groceries (non-prepared food), construction and rental services which includes all building, leasing and renting and the work on those buildings such as ground upkeep and security and a category of all other exemptions which helps make it all add up. Business to Business is also a category and we can check this or not, depending on the issue. That is hard to estimate because we don't know when a business buys something we don't have a record of all these transactions. Their has been an estimate by Bill Fox that is around 30 or so percent of all transactions are business to business. Also there is a D stamp tax, statewide real estate transfer to that can be added onto the bottom to see what that yields because if you include construction, you may want to eliminate this category. Roughly 27 percent of all NC transactions are taxed under our current sales tax. Based on the choices we make, the tax calculator tool will estimate how we expect sales tax revenue to grow over time. Also, this is in comparison to estimated income growth in our state. The calculator clearly shows that the sales tax revenue doesn't keep up with overall income growth.

The remainder of the meeting was spent working with the calculator and implementing various scenarios. With so many different formulas, the conclusion of the committee was unanimous in that we have a long road ahead of us but the end result will be bitter sweet.

The next meeting will be held on February 19th at 1:00 P.M. The meeting adjourned at 1:10 P.M.